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he current U.S. financial crisis has been accompanied by an alarming number of judicial decisions that have eroded the rights of secured lenders under unambiguous provisions in their loan documents and under applicable law. Ironically, this comes at a time when secured lending, which has served for decades as the cornerstone of financing for the U.S. middle market, is playing a crucial role in the rehabilitation of the U.S. economy. Six recent cases illustrate this rising tide of "anti-creditism."[1]

In *Wells Fargo Bank v. Lake of the Torches Econ. Dev. Corp.,*[2] a Wisconsin federal district court declared a $46.6 million indenture to be void on the theory that typical cash dominion provisions in the indenture, coupled with consent rights in management and the right to appoint a receiver upon default, gave the lender "significant control" over the management of the borrower (a Native American tribe). These rights, according to the court, transformed the indenture into a "management contract" that was void because the lenders failed to obtain the prior approval of the National Indian Gaming Commission (whose approval was required for management contracts). The Court refused to permit the lender to sever the offending clauses from the indenture, referring to the indenture as a "package deal" — albeit an unenforceable one — presumably leaving the lender with no recourse to collect the money it had loaned. This ruling is on appeal to the Seventh Circuit.

In *In re Tousa, Inc.,*[3] TOUSA, Inc. and various of its affiliates were co-borrowers on loans made to finance a litigation settlement. The Florida bankruptcy court invalidated the guaranties as fraudulent conveyances on the theory that the affiliates were not parties to the underlying litigation and therefore received no benefit from the loans. In the process, the court held that standard "savings clauses" of the type used in guaranties and co-borrowing arrangements for decades were unenforceable. These clauses seek to preserve the guaranty or co-borrowing arrangement from a fraudulent conveyance attack by reducing it to an amount that would not render the affiliate insolvent under the Bankruptcy Code or state fraudulent conveyance laws. The court branded the savings clauses as "too cute" and "inherently distasteful," and an attempt by "clever lawyers" to circumvent the provisions of the Bankruptcy Code. The ruling is technically *dicta*, since the court also found that the affiliates were hopelessly insolvent and that the savings clauses would have had no effect even if they were enforceable. However, the decision is troubling, not only because it is wrong on the law, but also because it is the first decision to address the enforceability of savings clauses. The case is currently on appeal to the Florida district court.

Tousa also illustrates anti-creditism in another way. The borrower misled the agent bank regarding its own internal assessment of the risk of the loan (i.e., it would leave the borrower "over-leveraged" and at risk of "crashing and burning"). But instead of blaming the borrower for not being forthcoming, the court blames the agent for the lender syndicate for failing to uncover this information in its due diligence, and also criticizes the agent for not appreciating soon enough the downturns in the home mortgage and housing markets, along with the adverse impact that these downturns would have on the borrower.

Blaming lenders for their borrowers' misrepresentations is also the theme in two other recent cases. In *DDJ Management, LLC, et al. v. Rhone Group L.L.C., et al.,*[4] the lenders received an unqualified audit for the year ending December 31, 2003. Prior to the issuance of the audit opinion, the borrower issued unaudited financial statements for 2004 that showed dramatic improvement over 2003. However, the improvement was based entirely on a non-GAAP accounting change in how the borrower handled reserves for obsolete inventory. The lenders were never informed of this

change, but relied on the borrower's representations that the 2004 unaudited financial statements were true and accurate and had been prepared in accordance with GAAP. A New York state court chastised the lenders for relying on the debtor's internal financial statements and financial representations, and imposed an unprecedented duty upon lenders to independently examine a prospective borrower's books and records. The court noted that, "[t]o sustain a claim for fraud, sophisticated investors...must have discharged their own affirmative duty to exercise ordinary intelligence and conduct an independent appraisal of the risks they are assuming."[5] The lenders have appealed the decision, and CFA has joined with the Loan Syndications Trading Association and the Clearing House in filing an *amicus* brief.

In *Siemens Financial Services v. Haband Company Inc.,*[6] when the lender performed a telephone verification of a major receivable, it was told by the vice president of operations of the customer that the balance was $4.8 million, whereas in fact it was $258,000. It turns out that the borrower's president had allegedly made clandestine payments totaling $315,000 to the vice president of operations to induce him to give the fraudulent verification. Both men were sent to prison. However, when the lender sued the account debtor for fraudulently inflating the receivable, the court found that the lender's reliance on standard telephone verifications "shocks the conscience of [the] Court." The decision was affirmed as this article was being written.[7]

In *BNP Paribas, as Agent, v. Olsen's Mills, Inc.,*[8] when the borrower defaulted, the lenders put the borrower into a Wisconsin Chap. 128 receivership, which is traditionally a very pro-lender proceeding that is often used as an alternative to Chapter 11, because the lenders were concerned about fraud and did not want to leave the current management in charge (even during a Chapter 11 case). Pursuant to the receivership statute, the receiver held a public auction, and Newco was the successful bidder. The statute requires the consent of the secured parties for any sale, and the lenders in fact consented to the sale and agreed to finance Newco. But, before the sale could be consummated, the judge threw out the successful bid and accepted a new bid, made by a friend of the borrower, that was handwritten on a legal pad and that did not conform to the approved bidding procedures. This is apparently the only case where the Wisconsin receivership statute was used to approve a bid over the objection of the secured creditors. CFA's *amicus* brief in this case has been accepted for consideration by the appellate court.

Finally, in *In re Yellowstone Mountain Club LLC,*[9] Credit Suisse loaned $375 million to a luxury resort in Montana, $24 million of which was earmarked for use in the resort's business, while most of the balance was dividended to the borrower's shareholders. Instead of subjecting the dividend to a typical fraudulent conveyance analysis, the Montana bankruptcy court dressed down the lender for its "naked greed" and "over-reaching and predatory" conduct and, as an extreme and unwarranted remedy, equitably subordinated Credit Suisse's secured claim to the claims of all unsecured creditors. The court vacated its ruling when the parties settled, so no appeal will be possible.

These six cases — by no means isolated examples of the rising tide of anti-creditism — reflect a disturbing trend. They represent a deterioration of secured lenders' rights under their loan documents and applicable law that is not only unwarranted from a legal perspective, but also introduces additional risk for secured lenders that will inevitably increase the cost, and reduce the availability, of secured credit in the United States at a time when the U.S. middle-market needs an abundant supply of secured lending more than ever. TSL

Footnotes:

1. "Creditism" is the term used by economist Tim Congdon to describe the "lending-determines-spending doctrine" advocated by Ben Bernanke and a derivative of Bernanke's term "creditist." See Tim Congdon, Did Bernanke's "Creditism" Aggravate the Financial Crisis of 2008, published in Macroeconomic Theory and Its Failings: Alternative Perspectives on the Global Financial Crisis (Steven Kates, Ed. 2010). The term "Anti-Creditism" is coined here as the hostility toward, and prejudice against, lenders and lending.
2. *Wells Fargo Bank v. Lake of the Torches Econ. Dev. Corp.,* 677 F. Supp. 2d 1056 (E.D. Wis. 2010).
3. *In re Tousa, Inc.,Case No.* 08-01435-JKO, Adv. Pro. No. 08-1435-JKO, Dkt. No. 658 (Bank. S.D. Fla. Oct. 13, 2009).
4. *DDJ Management, LLC, et al. v. Rhone Group L.L.C., et al.,* 60 A.D.3d 421, 875 N.Y.S.2d 17 (N.Y. App. Div. 1st Dept. 2009).
5. *DDJ Management,* 60 A.D.3d at 424.
6. *Siemens Financial Services v. Haband Company Inc.,* Dkt. No. L-7453-06 (Sup. Ct. N.J. July 31, 2008)
7. *Siemens Financial Services v. Haband Company Inc., et al.,* Dkt. No. A-2738-08T2, slip op. (Sup. Ct. N.J. App. Div. May 25, 2010).
8. *BNP Paribas v. Olsen's Mills, Inc., App.* No. 2009 AP 001007 DV. (Wis. Cir. Ct., Apr. 14, 2009).
9. *In re Yellowstone Mountain Club LLC,* Case No. 08-61570-11, Adv. Pro. No. 09-00014, Dkt. No. 289 (Bankr. D. Mon. May 13, 2009).

Richard M. Kohn is a principal in Goldberg Kohn Ltd., a Chicago-based law firm, and co-general counsel of CFA. Randall Klein is also a principal in Goldberg Kohn Ltd., chair of the firm's Bankruptcy Group and a member of the Advisory Board of the CFA Education Foundation.